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FEDERAL COMMUNICATIONS COMMISSION
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BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

Washington, D.C.

In the matter of:	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 92-266
Protection and Competition	)	
Act of 1992	)	
	)	
Rate Regulation	)	

SUPPLEMENTAL COMMENTS OF THE MEDIUM-SIZED OPERATORS GROUP ON PETITIONS FOR RECONSIDERATION

Adelphia Communications Corporation
Bresnan Communications Company
Cablevision Industries Corporation
Cablevision Systems Corp.
Century Communications Corporation
Columbia International, Inc.
Falcon Cable TV
Hauser Communications
InterMedia Partners
Jones Spacelink, Ltd.
Lenfest Communications, Inc.
Marcus Cable
Prime Cable
RP Companies, Inc.
Simmons Communications, Inc.
Star Cablevision Group
Sutton Capital Associates
Triax Communications Corp.
United Video Cablevision, Inc.
US Cable Corporation

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SUMMARY

The medium-sized operators group (the "Group") generally supports the Commission's benchmark approach to rate regulation. As discussed herein, the Group proposes modest, specific changes to the benchmark rules which, it believes, will alleviate some of the unintended effects of the present benchmarks, and obviate the need for the majority of cable operators to conduct cost-of-service showings.

The Group has worked extensively with economists, accountants, and financial analysts from Ernst & Young in order to propose specific, and workable adjustments to the benchmarks. Specifically, the Group proposes that: (1) the benchmark formula should be modified to more closely reflect the higher costs of satellite programming and more accurately reflect the capital costs of rebuilds and upgrades; (2) operators that completed rebuilds after September 30, 1992 should be permitted to use their currently effective rates and number of channels in Worksheet 2 of FCC Form 393; (3) benchmark rates should be adjusted upward for (i) systems with a home density of 50 homes per mile or less and (ii) systems operating in the State of Alaska; (4) consumer equipment used to access premium services and to provide multimedia services should not be regulated, even though the same equipment also provides access to the basic tier; and (5) the Commission should permit cable operators to charge basic tier subscribers a subscriber line charge to recover the cost of providing the basic distribution plant.

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SUPPLEMENTAL COMMENTS OF THE MEDIUM-SIZED OPERATORS GROUP ON PETITIONS FOR RECONSIDERATION

The medium-sized operators group[1] ("the Group"), by its attorneys, and pursuant to Section 1.429 of the Federal Communications Commission's ("FCC or Commission") rules, hereby submits the following supplemental comments on the Petitions for Reconsideration of the Commission's Report & Order, FCC 93-177, MM Docket No. 92-266, (released May 3, 1993).

I. INTRODUCTION

As stated in its Comments filed July 21, 1993, the Group fully supports the benchmark approach. The Group believes that by making certain modifications to the benchmark regulations, and by eliminating certain anomalies in the benchmark rate formula, benchmark rate regulation can be

[1] The members of this group include: Adelphia Communications Corporation, Bresnan Communications Company, Cablevision Industries Corporation, Cablevision Systems Corp., Century Communications Corporation, Columbia International, Inc., Falcon Cable TV, Hauser Communications, InterMedia Partners, Jones Spacelink, Ltd., Lenfest Communications, Inc., Marcus Cable, Prime Cable, RP Companies, Inc., Simmons Communications, Inc., Star Cablevision Group, Sutton Capital Associates, Triax Communications Corp., United Video Cablevision, Inc., and US Cable Corporation.

implemented fairly and without the need for extensive cost-of-service showings.

The Group, with the assistance of economists and financial analysts from Ernst & Young ("E&Y"), offers the following critique of the Commission's benchmark formula and proposes specific suggestions intended to alleviate some of the unintended effects created by the current benchmark scheme.

II. THE STEP-WISE REGRESSION PROCEDURE USED BY THE COMMISSION FAILED TO INCLUDE STATISTICALLY SIGNIFICANT VARIABLES

The FCC's benchmark rate tables are the product of a formula which uses "step-wise regression" analysis. As discussed in the attached paper by E&Y, the step-wise regression procedure is not favored by most economists because it tends to exclude independent variables that are highly correlated with each other, leading to biased results. The Commission's formula identified only three cable system characteristics as being responsible for determining cable television rates: the number of subscribers; the number of non-premium satellite channels; and "competition" as defined by the Cable Television Consumer Protection and Competition Act of 1992 ("the Act"). The Group submits that: (i) the analysis should have included additional cable system characteristics, namely, programming costs, rebuild costs and system density, in the calculation of the benchmark rates; and (ii) the failure to incorporate these variables into the benchmark formula has lead to inaccurate results. <u>See</u>, E&Y Paper at p.5.

III. THE BENCHMARK RATES DO NOT ADEQUATELY COMPENSATE CABLE OPERATORS FOR THE COST OF PROGRAMMING

The Commission recognized that the programming costs for satellite (or cable programming) channels are generally higher than the programming costs for non-satellite channels. Thus, the benchmarks do provide for a higher per channel rate for satellite channels than for non-satellite channels. For example, suppose two cable systems, both with more than 10,000 subscribers, each have 40 regulated channels. System 1 has 10 basic tier and 30 satellite channels, and System 2 has 20 basic and 20 satellite channels. Based on the benchmark tables, System 1 may charge $22.30 for all 40 channels, which is $0.88 more than the $21.48 which System 2 may charge for all 40 channels. E&Y Paper, Section 1(a).

The problem is that, notwithstanding this differential, the benchmarks still do not reflect the actual costs of satellite programming. In the above example, System 1, with 10 more satellite channels than System 2, is compensated only an additional $0.88 in total, or 8.8 cents for each additional satellite channel, whereas the actual average cost of national satellite programming is about $0.20 per channel.[2] E&Y Paper at

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[2] The Group estimates that there are approximately twenty-seven national channels of non-premium cable programming service currently available to cable operators at an average base cost of about $0.20 per channel per month. (This average does not even include the regional sports programming channels which have an average cost per subscriber per month which is approximately 170% greater than that of the national cable programming services.)

p.6. See, Declaration of Leo J. Hindery, Jr., attached as Exhibit 1.

As described more fully by E&Y, by adding a variable to the FCC's formula based on the number of channels in the basic tier, System 1 would be able to charge an additional $2.20 for all 40 channels, which would produce an effective rate per satellite channel much closer to the actual average cost of programming. The Group believes that this minor adjustment would make initial benchmark rates more compensatory, and would obviate the need for cost-of-service showings in many instances.

On a going-forward basis, however, the Group emphasizes that the actual programming cost for each additional satellite channel must be treated as external to the benchmark price cap. While the Commission has determined that increases in programming costs above inflation (other than retransmission consent fees) may be passed-through to subscribers,[3] the issue with respect to the treatment of programming costs for new cable programming channels has not been addressed.[4] Because the current per channel benchmark rate does not compensate the operator for the

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[3] Report & Order at ¶ 251. The Group notes, however, that external treatment for passing through increases in programming costs above inflation begins on "the date which the basic service tier becomes subject to regulation or 180 days after the effective date of our regulations . . . whichever occurs first." Id. at ¶ 255. This creates a regulatory vacuum with respect to external costs incurred between September 30, 1992 and September 1, 1993, and the present benchmark rules provide no mechanism to account for costs incurred during this one-year period.

[4] Id. at 253, n. 604.

actual cost of the satellite channels already being carried, there is no incentive for operators to add more satellite channels. *See* E&Y Paper, Section 1(b).

Using the example above, if System 1 adds 5 satellite channels, the current benchmark formula allows only an $0.68 increase over the previous rate of $22.36 for 40 channels, or an average of just $0.14 per new satellite channel. Again, the incremental increases allowed under the benchmark formula will likely not compensate the operator for the actual cost of programming (and for the capital, marketing and administrative costs to add those channels).

To encourage the addition of quality programming on cable systems, it is important that the Commission's price cap formula be adjusted to account for the actual cost of the programming. The Group proposes that, at a minimum, programming costs for channels added after September 1, 1993, plus the related start-up marketing costs and a reasonable profit, should be added to the price cap as external costs. Once the channels are added to the system and rates are adjusted accordingly, increases in programming costs above inflation would be external to the price cap. E&Y Paper at p.9.

IV. THE BENCHMARK RATES DO NOT ADEQUATELY COMPENSATE CABLE OPERATORS FOR THE COSTS ASSOCIATED WITH SYSTEM REBUILDS AND UPGRADES

The benchmark tables and the associated worksheets establish a cable operator's "initial regulated rate" from which subsequent rates may be increased only pursuant to the

Commission's price cap mechanism. Therefore, it is crucial that the benchmark formula does not set an artificially low rate. As discussed above, the benchmarks and the price cap mechanism do not accurately reflect the cost of satellite programming, creating a disincentive to add quality cable programming. As discussed below, the benchmarks also do not adequately compensate operators for the capital costs associated with system rebuilds. Since upgrades and rebuilds are, in many instances, required by the franchise authority,[5] such operators now face the prospect of cost-of-service showings to recover their capital costs.

There may be several factors working together to drive the benchmark rates below non-compensatory levels. First, as previously stated, programming costs are not adequately accounted for in the benchmark formula. Second, had the Commission solicited cost information in the September 1992 cable survey, the benchmark formula may have been able to account for the capital costs and related costs associated with rebuilds. Third, there is no information in the FCC's survey to indicate whether an operator had recently upgraded/rebuilt a system. Thus, there is no way to know whether the surveyed cable systems (from which the benchmarks were derived) were "mature" systems, recently rebuilt, or need to be rebuilt because of aging facilities. Although such characteristics impact rate levels, the survey did not take these factors into account. E&Y Paper, Section 2(a).

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[5] As the Commission is aware, failure to comply with franchise requirements could result in revocation of the franchise.

A. Accounting for the Cost of Future Capital Improvements

The Group supports the majority of Petitioners that urged the Commission to allow cable operators to recover their full capital investment in system expansions and upgrades.[6] As noted above, the benchmark tables do not adequately reflect the actual cost of programming, or the capital costs associated with rebuilds. On average, it costs cable operators approximately $600 per subscriber in capital costs, including the cost of addressable converters, for a rebuild. Alternatively, the cost is approximately $130 to $250 per subscriber in capital expenditures to electronically upgrade a system. (Neither of these estimates include programming costs.) In contrast, the incremental rates per additional channel allowed to cable operators under the benchmarks, expressed on a going-forward per channel basis, are substantially less than these costs.

An examination of actual costs for eight recent rebuilds illustrates the problem. As shown in Section 2(c) of the E&Y Paper, operators do not recover their capital costs under the benchmark scheme, and this does not even consider the additional revenue required to cover programming costs, marketing costs, or other overhead. The actual rebuild costs per channel per subscriber compared with the additional revenue per channel allowed under the benchmarks, left these eight systems with margins before programming costs of between -$0.09 to $0.08. E&Y

[6] See, e.g., Viacom Petition at p.4; NCTA Petition at p.19; Corning Petition at p.5.

Paper at p. 12. As noted above, these margins do not provide the systems with sufficient incremental revenue to recover even the additional average programming costs of $0.20 per channel.

Therefore, the Group urges the Commission to permit cable operators the opportunity to apply for external treatment for the capital costs of rebuilds under streamlined cost-of-service rules. See, E&Y Paper at p.13. Specific proposals on streamlined cost-of-service showings to account for rebuilds will be addressed by the Group in the Commission's cost-of-service rulemaking.

B. Operators That Initiated Rebuilds and Upgrades Prior to the Date of Initial Regulation Are Unfairly Penalized

In addition to being generally non-compensatory in relation to the actual capital cost incurred for rebuilds, cable operators that completed upgrades and rebuilds after September 30, 1992 are doubly penalized because the base rate per channel is lower than the base rate the same system would have received if the rebuild was completed before September 30, 1992.

The E&Y Paper offers an example of a system being unfairly penalized as a result of completing a rebuild after September 30, 1992. E&Y Paper, Section 2(b), and Attachment 1. In this example of "the Worksheet 5 problem," the system completed a rebuild after September 30, 1992 and obtained a maximum permitted rate (after completing Worksheets 1, 2, and 5) of $22.52 for all 42 channels. E&Y Paper, Attachment 1. Using the same system information, the Worksheets were completed as if the operator had completed the rebuild before September 30, 1992, in which case the maximum permitted rate for all 42 channels becomes $24.33.[7] Simply by completing the rebuild before September 30, 1992, the operator would be permitted to charge an additional $1.81 per subscriber per month, about $670,000 in annual revenues. E&Y Paper at p.10. In addition, some operators that completed rebuilds after September 30, 1992 may be forced to make rate reductions in excess of the maximum 10% rollback. E&Y Paper at p.11.

To rectify these problems, the Group proposes the following remedy for cable systems caught in this particular circumstance. For operators that completed rebuilds and initiated rate increases after September 30, 1992, and are above the benchmark (which requires the completion of Worksheet 2), line 201 should be completed using currently effective rates. The remainder of Worksheet 2 would be completed without change.[8] E&Y Paper at p.10.

This small change, which would be applicable only to a small number of cable operators caught in the transition from an unregulated to a regulated environment, would at least allow

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[7] It should be noted that a common practice in the cable industry is to phase-in rate increases to recover capital costs, so as to avoid imposing large rate increases on subscribers in a given year. Thus, the initial post-rebuild rate may not reflect the capital cost of the rebuild. On a going-forward basis, the Commission must consider the effect of the phase-in of capital costs in the price cap formula.

[8] Using currently effective rates in Worksheet 2 would obviate the need to complete Worksheet 5.

operators to make rate reductions based on post-rebuild rates, rather than on pre-rebuild rates. As the Commission is well aware, rebuilds and upgrades are, in most cases, franchise requirements. Moreover, financial commitments and construction contracts for these rebuilds had been made well before the passage of the 1992 Cable Act. Therefore, it would be fundamentally unfair to penalize these operators for good faith compliance with their franchise requirements and prior commitments.[9]

V. THE BENCHMARK RATES SHOULD BE ADJUSTED UPWARD FOR SYSTEMS WITH A DENSITY OF LESS THAN 50 HOMES PER MILE

As discussed above, the benchmarks do not in general adequately compensate cable operators for the average capital costs for rebuilds and upgrades. However, capital costs, as well as operational costs, are even higher per subscriber in low density areas. The FCC's examination of its data did not find an impact of homes density on price. Report & Order at ¶ 210. However, as E&Y explains, the home density variable is statistically significant and should have been accounted for. See, E&Y Paper at p.13.

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[9] In addition, some cable operators were hindered in their ability to increase their rates following the completion of a rebuild as a result of the FCC's Freeze Order, 8 FCC Rcd. 2921, clarified, 8 FCC Rcd. 2917 (1993). Operators that were prevented from increasing their rates following a rebuild because of the Freeze Order should also be permitted to use the "post-rebuild rate" in line 201 of Worksheet 2.

Again, using factual examples, the impact of home density on capital cost per subscriber is clear. While the distribution plant costs between $100-110 per subscriber in high density areas (over 200 HP/mile), capital and construction costs per home passed in low density areas (less than 50 HP/mile) range between $425 to $650. E&Y Paper at p.15, Figure 1. According to the data provided by the Group's members, E&Y found that total monthly costs are 24%-37% higher in low density areas. E&Y Paper at p. 17.

Given the time constraints, E&Y was only able to review specific cost information for a sample of cable systems. While this data is insufficient to derive a specific rate adjustment factor, the data clearly suggests that home density is a significant variable, which must be further considered by the Commission. Until the Commission can determine the appropriate density adjustment for low density systems, the Group proposes, as an interim measure, that cable systems with less than 50 homes passed per mile should be exempt from the 10% rollback requirement. This is supportable since the data suggests that low density systems have total monthly costs (operating and capital-related) which are on average 37% higher than those of higher density systems.

VI. THE BENCHMARK RATES SHOULD BE ADJUSTED UPWARD FOR SYSTEMS LOCATED IN ALASKA

It is well established that the costs of providing communications services in the State of Alaska are much higher than the lower 48. For example, in Prime Cable's systems in Alaska, annual operating costs are approximately $309 per subscriber compared with $200 per subscriber in similarly sized systems in the lower 48. E&Y Paper at p.17. The construction costs of distribution plant per home passed in Bethel is approximately $583, compared with $230-$275 for systems of similar density in the lower 48 states. E&Y Paper at p.17.

These facts clearly demonstrate that cost of providing cable television service in Alaska is well in excess of the cost of providing such service in the lower 48 states. The Group does not propose at this time a specific rate adjustment factor to account for these higher costs, but submits that the Commission must reconsider its benchmarks to the extent that Alaska is treated the same as the lower 48 states. Until the Commission can establish an appropriate rate adjustment for Alaska, the Group believes that cable systems serving Alaska should be exempt from the 10% rate rollback.

VII. EQUIPMENT NOT REQUIRED TO ACCESS THE BASIC TIER SHOULD NOT BE SUBJECT TO RATE REGULATION

The majority of Petitioners urged the Commission to reconsider its determination to regulate virtually all customer premises equipment used in the provision of cable television service.[10] The Group agrees with these Petitioners' arguments

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[10] See, e.g., Petitions filed by Time Warner, NCTA, Continental Cablevision, Inc., and Colony Communications, et al. See also, Comments of General Instrument Corporation in Support of Petitions for Reconsideration.

against the FCC's over-inclusive approach to the regulation of equipment. The Commission's requirement that operators develop rates based on actual cost for equipment required to receive basic service "regardless of whether this equipment or installation is also used to receive a higher level of cable service"[11] will effectively regulate the rates for consumer equipment used to receive services above the regulated basic and cable programming tiers. The Group does not believe that this was Congress' intention, and believes that such a policy will stifle the development of "enhanced" equipment as the cable television industry begins to provide computer-enhanced services and fully-digital systems.[12]

In adopting this broad interpretation of the Act, the FCC "believe[d] that Congress intended our regulations to encourage a competitive market in the provision of equipment and

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[11] Report & Order at ¶ 406.

[12] The industry is now in the process of implementing digital compression to dramatically increase channel capacity, which will require digital decompressors incorporated into the subscriber's converter box. Time Warner, TCI, Comcast, Newhouse, Sammons, and Cablevision Industries have all announced 1994 deployments of to-the-home digital compression. See, "Planning the Cable System of Tomorrow," Cablevision Magazine, April 19, 1993; "Time Warner's Full-Service Network," Cable World, March 22, 1993. Companies such as Intel Corp., Microsoft Inc., General Instrument, Scientific Atlanta, Jerrold Communications, Inc., United Video, Inc., EMI Communications, and Zenith are also working on hardware and software packages for interactive home shopping, channel directories and a host of multimedia databases, leading to the integration of computer functions in cable TV home converters. See, "Firms link for 'smart cable box," Multichannel News, April 19, 1993; "IBM, DEC Strengthen Their Links to Cable," Cable World, May 17,1993; "Going Interactive," Cable World, June 7, 1993.

service installation" but concluded that it lacked sufficient data to develop an "effective competition test." Report & Order at ¶ 282. The Commission assumed that a competitive market for equipment does not exist because converter boxes and remotes were specifically listed in §623(b),[13] and "Congress determined that developing a competitive market for equipment required additional study by this Commission," citing, §624(a) of the Act (the equipment compatibility section). However, §624(a) requires only that the Commission address technical and system security issues. There is nothing in §624 that remotely implies that the Commission study the state of competition in the equipment market.[14] The Group submits that the Commission's assumption that competition does not exist in the equipment market is tenuous at best, and contrary to the available evidence. See, note 12, supra. Therefore, the Commission's reliance on this assumption to justify its broad regulation of all customer equipment is flawed.

The Commission also believed Congress changed the statutory language "to give the Commission greater authority to protect the interests of the consumer" and that "regulating

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[13] Section 623(b) is, of course, the section relating to basic tier rate regulation only. Regulation of cable programming services is set forth in Section 623(c) of the Act.

[14] In fact, nowhere in its Notice of Inquiry on equipment compatibility did the Commission request information on, or discuss, the state of competition in the cable consumer electronic market. Compatibility Between Cable Systems and Consumer Electronics Equipment, "Notice of Inquiry," ET Docket No. 93-7, FCC 93-30 (released January 29, 1993).

identical equipment differently depending on the level of service . . . will lead to customer confusion." Id. at ¶ 283. In fact, the Commission's present policy will have the effect of increasing customer confusion, and it will complicate the goal of the §624(A) of the Act which directs the Commission to establish equipment compatibility rules.

This over-inclusive policy is a disincentive for cable operators to provide integrated, more efficient equipment. Rather, the policy encourages operators to offer at a minimum, two separate sets of equipment, namely, "basic-only," which can only access the basic tier, and "advanced" equipment, which will do everything except access the basic tier. Separating the "basic" functions from the "non-basic" functions will, of course, increase the actual cost of the equipment, and increase the complexity of the interfaces, which will create customer confusion as well as complicate the compatibility issues. Subscribers (other than basic-only subscribers) would be required to have separate converters and remotes for basic and cable programming services, and would be forced to purchase or lease additional, unnecessary equipment. Such results are contrary to the stated findings and goals of the Commission.[15]

Further, the Commission recognized that "the technology for cable equipment is rapidly changing and Congress did not

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[15] As the Supreme Court stated in Duquensne Light Co. v. Barasch, 488 U.S. 299, 310 (1989), citing, FPC v. Hope Natural Gas, 320 U.S. 591 (1944): "[I]t is not theory but the impact of the rate order which counts." (Emphasis added).

intend to inhibit innovation." Id. at ¶283, n.671. The FCC acknowledged that converters will begin to have "numerous functions" and that initially "these devices might have very high costs." Id. Recognizing that market forces limit the amount an operator may charge for "enhanced" converters, the Commission notes that operators may offer such expensive converters below actual cost, i.e., on a "promotional" basis, and make up the difference by charging more for premium channels.[16] There is nothing in the 1992 Cable Act which suggests that revenue from non-regulated services must subsidize the regulated services.

The continued development and expansion of the cable television infrastructure toward the provision of new services, including computer-enhanced and interactive applications, is one of Congress' explicit policy goals of the 1992 Act, as well as a long-standing Commission policy.[17] In fact, the policy reasons articulated by the Commission for deregulating enhanced

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[16] Unless the operator wants to absorb promotional costs or undertake a cost-of-service showing, it will have to force premium channel subscribers to subsidize lower tier subscribers because, under the present benchmark rules, promotional costs may only be recovered in a cost-of-service showing through an allocation to general overhead.

[17] See, §§ 16 and 624 of the Act; 47 U.S.C. § 157; Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, "Cost-of-Service NPRM," MM Docket No. 93-215, FCC 93-353 (released July 16, 1993) at ¶ 9, n.12 and cases cited therein.

communications services applies equally to enhanced video services. In the Second Computer Inquiry,[18] the FCC observed:

> With the nonregulation of all enhanced services, FCC regulations will not directly or indirectly inhibit the offering of these services, nor will our administrative processes be interjected between technology and its marketplace applications . . . The trend in technology is toward new and innovative enhancements that build upon basic services. . . As a result, the types of enhanced services [vendors] may provide is limited only by their entrepreneurial ingenuity and competitive market constraints. Services need not be artificially structured or limited so as to avoid transgressing a regulatory boundary.

77 F.C.C.2d at 429. Similarly, in adopting its video dialtone rules,[19] the Commission established a two-level regulatory structure whereby telephone companies must offer on a non-discriminatory basis a "basic platform offering" as the first level of service. The second level of service would include enhanced, non-regulated services. In adopting this two-tier approach, the Commission stated:

> [W]e believe that the public interest is best served by letting the market place, rather than the government, determine the precise nature of such enhanced services, including video gateways. . . For instance, while a video gateway might include customized menus and directories which allow the subscriber to select programming or information services tailored to individual preferences, we do not require any such functionality.

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[18] 77 F.C.C.2d 384 (1980), on recon., 84 f.C.C.2d 50 (1980); further recon., 88 F.C.C.2d 512 (1981); aff'd. Computer & Communications Indus. Ass'n. v. F.C.C., 693 F.2d 198 (D.C.Cir.1982); cert. denied, 461 U.S. 938 (1983).

[19] Video Dialtone Order, 71 Rad.Reg.2d 70 (1992).

71 R.R.2d at 86. These policies apply equally to enhanced cable television subscriber equipment. The Group believes that enhanced cable television equipment should be treated no differently than similar equipment provided by telephone companies and video dialtone providers. Application of long-standing Commission policies in a consistent manner dictates that rates for equipment primarily used to receive premium and enhanced services, such as multimedia applications, should not be regulated.

VIII. THE "TIER-NEUTRAL" SCHEME RESULTS IN CONFISCATORY RATES FOR BASIC TIER SERVICE

Virtually all Petitioners urged the Commission to reconsider its decision to regulate rates for the basic tier and cable programming services tiers using the same benchmark formula. The Group agrees with legal arguments made by Time Warner and others[20] that Congress did not intend to establish a "tier-neutral" regulatory regime, and the Group shall not reiterate those legal issues here.

However, at a minimum, tier-neutrality severely limits an operator's ability to recover its costs associated with providing the basic tier. The undisputable fact remains that there are fixed costs associated with providing the essential distribution plant necessary to provide the basic tier. The cost per subscriber to provide the capital and to maintain the cable

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[20] Time Warner Petition at p.4. See also Petitions of NCTA, Tele-Communications, Inc., Continental Cablevision, Inc.

infrastructure is approximately $20 per month, excluding programming costs. See, E&Y Paper at p.17. The fixed cost of providing the basic tier is much greater than the revenue received for that tier under the benchmark formula.

The Group proposes that the Commission adopt a "subscriber line charge" applicable only to subscribers that purchase only the basic tier. Such a policy would be consistent with the Commission's policies adopted in MTS & WATS Market Structure: Third Report & Order, 93 F.C.C.2d 241 (1983)("Access Charge Order").[21] In its Access Charge Order, the FCC permitted telephone companies to recover the cost of the local telephone plant through a flat per line charge billed to customers because local charges covered only 74% of the costs of the basic local network. The remaining costs were recovered from long-distance fees paid by long-distance callers.[22] The impetus for adopting access charges was the threat of "uneconomic bypass" which occurs when

> 'uneconomic' technologies pose[] a threat to the local telephone network when, as under the current system of charges, access to the local telephone network, for heavy interstate users, is priced above costs. This ultimate concern influenced the FCC's course: if large users left the network and turned to bypass technologies, the local companies would have to raise the rates paid by their remaining subscribers, thus jeopardizing universal service.

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[21] On recon., 48 Fed.Reg. 42984 (1983), further recon., 49 Fed.Reg. 7810 (1984), aff'd. National Ass'n. of Reg. Util. Com'rs. ("NARUC") v. F.C.C., 737 F.2d 1095 (D.C.Cir. 1984).

[22] NARUC v. FCC, supra, 737 F.2d at 1105.

Id. at 1108. This situation is analogous to the cable television industry under rate regulation. Video cassette recorders (VCRs), TVRO dishes, and DBS services will provide cable operators with competition with respect to premium services, and services offered on the cable programming tier. If cable companies cannot recover the costs of the basic distribution plant, they will be forced to raise rates for non-regulated premium services, since all other rates are capped. By raising the rates for premium and a la carte channels, the risk is increased that subscribers will "bypass" the cable operator's premium services and obtain such channels via alternative video distributors, such as TVRO dealers or DBS satellites.

As the D.C. Circuit Court stated in affirming the FCC's access charge policy

> Local telephone plant costs are real; they are necessarily incurred for each subscriber by virtue of that subscriber's interconnection into the local network, and they must be recovered regardless of how many or how few interstate calls a subscriber makes.

737 F.2d at 1114. Similarly, the costs of the cable television distribution plant is real, regardless of how many subscribers receive premium channels and other non-regulated services. If the FCC continues to believe cable television rates must be tier-neutral, then the basic costs of providing and maintaining the physical plant must be recovered without raising non-regulated rates. Allowing operators to charge a subscriber line charge to basic-only subscribers would keep the tier-neutral scheme intact, and ensure the operators are fairly compensated for the essential

distribution plant. Without such a mechanism during the transition to a competitive video programming market, cable operators will not receive compensatory rates for basic-only service.

IX. CONCLUSION

The Group is deeply concerned that the benchmarks, in their current form, do not provide cable operators with the incentives to undertake rebuilds, improve technology, and add quality cable programming. Unless the benchmarks can be revised to provide higher compensation as operators add channels and recover programming costs, it will be extremely difficult for cable operators to attract sufficient capital to rebuild and upgrade their systems. Without rebuilds, subscribers will not have access to more channels and better technology, cable operators will not be able compete with DBS, and the recent trend toward ownership concentration will accelerate, as small and medium-sized operators are forced out of the industry.

If the Commission chooses to adopt the changes proposed by the Group, the majority of the nation's cable systems will still be above the benchmark, requiring some rollbacks. However, a proper balance will be achieved in implementing the consumer-interest goals of the Act and the economic realities of the cable industry, while furthering the technological development of an advanced telecommunications infrastructure. In addition, the modest modifications to the benchmark proposed by the Group will serve the interests of cable subscribers, franchising authorities, the Commission and the cable industry by largely eliminating the need for costly and time-consuming cost-of-service showings.

Based on the foregoing, the Group respectfully requests that the Commission's benchmark rules be modified as discussed herein.

Respectfully submitted,

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